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"In the early spring of 1928 a visit to the office of the new governor of the Federal Reserve Board, Roy A. Young , found him standing before the news ticker in his office, laughing. Stocks had had a sharp rise that day. Asked what he was laughing at, he said: 'I'm laughing at myself sitting here and trying to keep twenty-five million people from doing what they want to do.' "

Benjamin M. Anderson, Economics and the Public Welfare, P.194
Liberty Press, Indianapolis

HIGHLIGHTS

The sharp declines in global stock and bond markets have given way to a desperate waiting game. Trapped in their positions, anxious speculators and investors pray for a rebound that will cut their losses and allow them to liquidate at least part of their holdings. That makes for shaky markets.

Unusually feeble rallies suggest that upward momentum has definitely been broken. The great "bull" trend has ended. Particularly, in the case of the dollar bulls, full-fledged despair has set in.

We review the speculative excesses that took place in Europe and the United States, analyze their cause, and identify enormous liquidity risks. It's impossible that such stupendous excesses could be adjusted in such a short space of time.

There is little doubt about the cause of the Great Financial Bubble: The steepest ever U.S. yield curve fuelled an unprecedented orgy of bond speculation and drove millions of investors to flee liquid money balances.

The "*dash from cash*" into securities and the associated mortgage financing boom created wealth and income out of nothing. But the bill has now come due. Liquidity, though seemingly abundant for a while, has suddenly evaporated.

We think the implications for financial markets and economies are frightening. The big structural shift from banks to non-bank financial institutions leaves the U.S. financial system more leveraged than ever before. That greatly increases the risk of a true financial crash.

We show that the eruptive growth of non-bank financial intermediaries led to the monetary paradox of a rampant financial speculation taking place against a backdrop of collapsing money growth.

The unwinding of the huge financial bubble has only just begun. The real big trouble will start when more people decide that they want to restore their depleted liquidity. Cash will no longer be trash as the selling of stocks and bonds accelerates.

For conservative investors, our advice remains the same: Preserve and increase liquidity at all costs. Shorter-term bonds in the hard-currency countries are the safest haven.

THE LULL BEFORE MORE STORMS

"Overreaction" . . . "excessive" . . . "not based in reality" . . . "oversold" . . . these are just a smattering of the standard excuses that pepper the apologetic financial research around the world in recent months. There's hardly a broker or analyst that resorts to any fundamental explanation to help elucidate the unprecedented financial happenings so far this year. Why? Because virtually no one foresaw the financial catastrophies that have taken place to date — first, a smashing of world bond markets; and more recently, a collapse in the U.S. dollar. Given this blatant failure to recognize and warn about the clear, obvious dangers of world economic and financial conditions, can anybody seriously believe that these blind sages and their standard excuses have any credibility?

Yet, we sense that optimism and complacency remain deeply ingrained; people with losses are ready believers. And years of conditioning to "buy on weakness" have still not been broken. While fear and confusion have been high and harried, there still has been no capitulation. That's a telling sign that the bust of the Great Financial Bubble is only in the early stages . . . or perhaps between stages. The fact is this: conditions remain hostile to financial markets. Rampant illiquidity has finally collided with inflated financial asset prices.

SEARCHING FOR THE FUNDAMENTAL TRUTHS

Any credible attempt to assess the longer-term outlook for currencies and financial markets has to start with one, all-important question: "Was the global financial boom of the past three-and-a-half years the greatest financial bubble in history . . . as we maintain, the Great Financial Bubble? Or was it a solid and healthful bull market underpinned by excellent "fundamentals" as asserted by Wall Street and the consensus?

The correct answer to this question is critical. If our bubble diagnosis is correct, by implication, it foreshadows that much worse is to come for financial markets. Solid, balanced fundamental conditions, on the other hand, suggest a possible, if not probable, recovery of most financial markets. Investors need to examine the fundamentals of the situation and decide.

Now, in the lull after the storm, when convictions and emotions are being tested, it's a good time to readdress this question. To understand causes is to understand everything. Though we have consistently analyzed and chronicled the speculative excesses of recent years, given the continuing, general denial that there ever was a speculative bubble in the world's financial markets, we feel it's necessary to present our case in a comprehensive way, once and for all. In this letter, we lay out the global dimensions of the bubble . . . why we deservedly dubbed it the Great Financial Bubble, the biggest in modern financial history.

ONE IGNORANCE BEGETS ANOTHER

As is embarrassingly evident, the entire world financial community was savagely blindsided by the global bond market crash of the past half year. That having been the case, one would expect some critical re-examination of the conditions that gave rise to this disaster. But so far, we notice very little. Most of the economic gurus who had whipped up the financial bubble with their self-serving crackpot theories are sticking to their illusions. In the main, they claim that it was errant markets and investors that caused the crashes, not their blindness and recklessness. Arrogance and ignorance tend to be good friends.

Unbelievably, these defrocked gurus even have the arrogance to pose the tried and tested theories of the old economic masters as a rude intrusion of reality. Symptomatic of this is this quote from one of the leading apostles of the new wave of crackpot theories: He whines, "*Could it be that in the New World Economic Order, the old-fashioned Laws of economics no longer apply? Could it be that low inflation can be bearish*

for bonds?" He apparently doesn't realize that the old-fashioned laws of economics have finally exposed his ignorance.

But seriously, how dangerous is the situation? It used to be the conventional wisdom among the European school of economists that the severity of depressions or financial crashes depended in direct proportion to the magnitude of the excesses that developed during the preceding boom. We're firm adherents to this rule of thumb. That's exactly why we continue to see immense risks — simply because the prior speculative excesses were enormous.

Global Capital Market Trends

Global Equities

Selected Markets, % Change

Country (July 20)	Month	YTD	Y-Y	Vs. 12-Mos. Hi	Vs. 12-Mos. Lo
Australia	2.9%	-3.4%	15.5%	-9.9%	15.5%
Canada	4.9%	-2.0%	12.1%	-7.2%	12.1%
France	6.2%	-9.2%	5.5%	-12.8%	8.0%
Germany	5.2%	-6.8%	13.9%	-6.8%	15.7%
Hong Kong	2.8%	-23.8%	37.0%	-24.3%	37.0%
Japan	-0.7%	14.3%	3.9%	-2.6%	15.4%
Mexico	0.9%	-12.7%	36.8%	-19.8%	36.8%
Spain	2.2%	-7.8%	13.0%	-15.6%	13.0%
U.K.	6.6%	-9.5%	9.0%	-12.1%	9.0%
U.S.	2.0%	-2.9%	0.8%	-5.3%	2.1%

Source: FTA Indices

Global 10-Year Interest Rates

Selected Markets		Basis Point Change				
Country (July 21)	Present Rate(%)	Month	YTD	Y-Y	Vs. 12-Mos. Hi	Vs. 12-Mos. Lo
Australia	9.62	1	298	249	-2	344
Canada	9.15	-26	253	202	-26	282
France	7.25	-29	162	48	-53	162
Germany	6.80	-28	125	28	-34	125
Japan	4.34	8	130	12	-7	131
Spain	10.36	-28	224	15	-68	254
U.K.	8.24	-40	214	73	-40	214
U.S.	7.24	4	144	105	-10	192

Source: Financial Times

Exchange Rates

Versus U.S. Dollar		% Change				
Country (July 22)	Present Rate	Month	YTD	Y-Y	Vs. 12-Mos. Hi	Vs. 12-Mos. Lo
Australia ($)	1.36	0.5%	7.8%	7.9%	-0.3%	12.1%
Canada ($)	1.38	0.8%	-4.0%	-7.5%	-7.5%	0.8%
France (FF)	5.44	2.0%	7.9%	7.2%	-2.1%	10.1%
Germany(DM)	1.59	0.2%	8.4%	7.3%	-2.4%	9.3%
Japan (Yen)	98.6	1.5%	11.7%	7.8%	-0.6%	12.2%
Spain (Pta)	131.1	0.6%	8.3%	4.6%	-2.3%	10.1%
U.K.(Sterling)	1.36	-1.8%	2.8%	1.3%	-2.5%	4.0%

THE GREATEST FINANCIAL BUBBLE EVER EXPLAINED

Our explanation begins with the practical question of what actually makes a "bubble." In essence, "bubble" is just another name for a rampant inflation in a particular asset market, tangible or financial. That contrasts with the more familiar manifestation of inflation in the prices of goods and services. Essentially, every asset bubble is driven by loose monetary policy which has the specific effect of glutting a certain asset market, inflating its prices relative to the general price level.

Crucial to the identification of an asset bubble is the strict distinction between two separate sources of investible funds — current savings and inflation defined in its broadest sense. To be able to draw this distinction used to be elementary fare in economic schools. If the total flow of lending and investing exceeded available savings, it simply followed that this excess of lending must be coming out of inflationary sources. And such inflation can only take place under a compliantly "loose" monetary policy.

How much of the money that has flooded the U.S. and global financial markets in the last two, three years came from current savings, and how much from inflationary sources? As a broad estimate, we think that in some countries — among them the United States — upwards of two-thirds of the money flooding into stocks and bonds came from inflationary sources. That's an incredible excess. The only thing that's even more incredible is that this much inflation could slip by undetected under the watch of monetary authorities and the so-called "vigilant" bond markets.

In any case, it's these inflationary sources of money that cause booms to turn into virulent, dangerous "bubbles." While the attendant crackpot theories serve to stoke the promise of ever-higher asset prices, the indispensable factor, as always, is an extremely loose monetary policy.

Without a doubt, the U.S. has had prolonged, wildly excessive monetary conditions. This, along with the fantastically speculative concepts it spawned in the financial markets, spilled over into the rest of the world. The U.S. financial bubble was the locomotive that led the runaway train of a giant global financial inflation. At first glance, it looks like it was one large, homogeneous bubble. But upon closer scrutiny, we see that it was a confluence of a cluster of different bubbles. Loose money was the common denominator to all of them. It's just that the inflationary consequences of this loose money bubbled up through an unusual variety of conduits.

Yet, most people in the markets still flatly reject the explanation of an inflation-fuelled bubble. The popular argument is that there can't be any inflation when consumer and producer price inflation is as low and/or declining as today. It's conveniently ignored that financial bubbles have typically occurred in times of very low price inflation. Two of the worst bubbles this century — 1927-29 in the United States and 1987-89 in Japan — coincided with zero price inflation.

This coexistence of low inflation and bubbling financial markets, seemingly paradoxical, has its logic. Low inflation tends to mislead most central banks into prolonged, excessive monetary looseness. It's this that precipitates the distortions that lead to a bubble. Not suspecting that an inflationary asset bubble is being unleashed, everybody hails and encourages the boom as a healthful result of low inflation, thus justifying ever higher asset prices. It's always exactly the same pattern of nonsense, misjudgement and mistakes.

THE BUBBLE DECONSTRUCTED

As pointed out, the Great Financial Bubble is really a combination of a number of separate bubbles. We begin our deconstruction of the financial mania with a closer look at the bubble in European bonds. This branch of the mania was clearly dominated by the international speculators who either bought bond futures or borrowed the currency of the bonds they purchased. It is only now, as the lagging statistics are finally reported, that we discover that the actual speculative excesses even surpassed our wildest imagination.

So far, we are aware of only one single official report that pinpoints the rampant international bond speculation, though without any specific qualitative or judgmental comment. Unfortunately, it only deals with one country — Spain. On page 23 of this OECD (Organization for Economic Co-operation and Development) report, the following statistics are revealed about Spain's capital flows in 1993:

> "*Portfolio investment* [. . .] *surged. In particular, reflecting favourable prospects for sizeable capital gains from the expected fall in interest rates, foreign investment into government paper, mainly bonds, rose to about PTAs 6 trillion* [some US $50 billion, ten times the average of the previous five years]. *However, foreigners wishing to avoid the exchange risk largely financed these purchases with short-term peseta loans provided by domestic financial institutions. This is seen in the equally steep growth of Spanish (short-term) loans to foreigners.*"

In relation to the size of the Spanish economy, $50 billion is simply staggering. A similar phenomenon happened in all of the other main European countries. All combined, it explains last year's boom in the European bond markets. All European countries show gigantic inflows of portfolio capital in their balance-of-payment accounts matched by huge short-term outflows. Essentially, that translates to the buying of long-term assets with short-term financing. Put the two together and you have speculation. In this case, a

massive international bond speculation was directly or indirectly financed by the banks of the recipient countries. In the cases of Britain, Germany and France, these sums ran to $150-200 billion each.

Actually, the immense portfolio capital flows from foreign investors into these European countries are largely a statistical fiction. Why? Because if most of the bond purchases by foreigners were financed with money borrowed in foreign currency, then there really wasn't a capital inflow.

As it turned out, the international speculators managed to bungle their speculative investment play in every possible way. To begin with, hoping to augment their expected capital gains on their foreign bond purchases, they leveraged their available equity capital 5 to 10 times and more. What this caused instead, was a multiplication of their losses.

Secondly, international investors, being unanimously bullish on the dollar and bearish on the DM (and therefore, by implication, bearish on all the European currencies) ended up borrowing in the wrong currencies. Rather than falling, as they anticipated, the DM and the DM-linked currencies soared, increasing their liabilities as the dollar plunged. In this way, the speculators robbed themselves of the potential currency gains on their foreign bond holdings. Had they borrowed in depreciating dollars, they would have paid lower interest rates and made a huge currency profit.

To add insult to injury, the speculators largely picked the wrong bonds. Emboldened by the new theory that global bond yields must converge in a world of free capital flows, they overweighted bonds in the higher-yielding European currencies. It was these bond markets that suffered the biggest losses. (See the table on page 3 reviewing recent capital market performances.)

While many leveraged speculators were cushioned by previous large capital gains, the great majority are now left holding positions that are under water. A considerable number have been ravaged by margin calls and forced sales.

But back to the pertinent question, our litmus test: Was this extraordinary boom in European bonds a "bubble" or not? Without a doubt, yes, because very little of the foreign bond purchases were related to the investment of savings. It was a rampaging speculation inflated to absurdity by the floods of money provided by the Euro-banks.

THE NORTH AMERICAN BUBBLES

The torrents of money that poured into the U.S. financial markets came from a host of inflationary sources. Taken together, these flows were vastly in excess of current domestic savings. But this resulting explosion of money flows into the markets occurred under strange and unprecedented circumstances: namely, collapsing broad money growth.

As a rule, asset price inflations were always associated with very rapid money growth, well in excess of GDP (Gross Domestic Product) growth. But this time, the exact reverse happened in the United States. During 1992-93, the height of the financial boom, nominal GDP grew 12.4% and stock prices rose by 20%. In comparison, broad money (M3) only expanded a minute 1.1% during this period. More in line with the economic recovery and the booming financial markets was the fairly strong debt growth of 10.5%.

It was a grotesque misunderstanding of this pathology that caused Wall Street to explain the boom in the financial markets as being driven by "excess liquidity." While that indeed is the normal pattern, just the

opposite happened. Conveniently ignored was the fact that the money stock was in a virtual free-fall relative to GDP.

Essentially, this raises a conundrum: How under these sharply deteriorating liquidity conditions can both an economic recovery and a rampant financial boom develop? Our answer is this: The liquidity squeeze did no harm because the desire and demand for liquidity fell even faster than its supply. What happened was that shrinking liquidity was more than offset by a flight from liquidity.

How could this happen? It goes back to the root cause — an excessively loose monetary policy. But let's first examine the mechanism. Take a look at the main buyers of U.S. stocks and bonds during 1992-93, listed in the adjacent table. We observe that all the major financial sectors were large players in the buying melee.

NET PURCHASES OF U.S. STOCKS AND BONDS: 1992-93
(in $Billions)

Federal Reserve	$64.0
Foreign Central Banks	113.0
Private Foreign Capital	167.0
U.S. Commercial Banks	174.0
U.S. Brokers	105.0
Mutual Funds	384.0
Private Pension Funds	52.0
State & Local Government Funds	105.0

Source: Federal Reserve, Flows of Funds

Clearly, these buyers were crucial in fuelling the boom in U.S. stocks and bonds. But what were the sources of all the money that they pushed into the financial markets?

Actually, this is widely known. In the case of central banks and commercial banks, it hardly needs explanation. They created the money. Most of the other monies shoved into the markets were derived from highly-leveraged yield-curve playing, the reinvestment of realized capital gains, and last but not least, the exodus of millions of small savers from low-yielding bank deposits into securities.

But this still leaves us with the monetary paradox we mentioned earlier: How could such a money deluge occur on Wall Street while broad money growth was collapsing? As we want to explain, this exotic combination has two chief causes that can be superficially lumped under the technical term "*accelerating money velocity.*"

MONETARY REVOLUTION AND PARADOX

The first cause of the U.S. money phenomenon lies in the vast structural changes in the U.S. financial system wrought by financial deregulation throughout the 1970-80s. This led to an expanding universe of non-bank financial intermediaries which operate outside the banking system. Members of this group include mortgage pools, brokers and securities dealers, finance companies, mutual funds, hedge funds, pension funds . . . etc.

Much has been written about the explosive growth of these institutions and their competitive struggle to supplant the commercial banks. Yet, few have grasped the inherent, far-reaching monetary implications of this drastic structural shift in the U.S. financial system. From a monetary perspective, the non-banks all have one important peculiarity in common: They create financial flows, just like the banks. But in contrast to banks, their credit creation has no counterpart in money creation. As a consequence, the rapid expansion of these non-bank financial intermediaries has effectively cut the link between credit and money growth. The money aggregates are therefore no longer a reliable measure of true inflation conditions.

The financial shift to the non-bank sector has been enormous. During the whole of the 1980s, U.S. non-financial debt (the debts of the public sector, corporations and private households) grew a total of $6.5 trillion. This was associated with broad money growth (M3) of $2.3 trillion. What we see is that for each $2.80 of new debt, one dollar was added to liquidity (M3).

By contrast during the last four years of extreme monetary ease, indebtedness skyrocketed relative to money and liquidity growth. While non-financial debt rose by $2.43 trillion, M3 only grew a paltry $141 billion. This time, $17.20 of new debt corresponded to every dollar added to liquidity. What's worse, this ratio continues to deteriorate. In the first quarter of 1994, broad money even shrunk by $16 billion versus $131 billion growth in non-financial debt. (Both figures are non-annualized.)

EXCESS EXOTICA

The overproportionate growth of non-bank financial institutions in the United States has been a long-running trend. The early 1990s, however, brought an eruption that turned the trend into a vertical take-off. Why? Wall Street likes to explain it as a function of better efficiency and competitiveness on the part of non-bank institutions. But that misses the key point. In reality, the true impetus for this boom was the Fed's prolonged, extreme monetary looseness. It sparked massive yield-curve playing by financial institutions and a stampede of individual investors out of bank deposits into mutual funds and securities.

Wall Street was only too happy to supply complicity. To satisfy the resulting insatiable demand for higher-yielding financial assets, the wizards of Wall Street embarked on a binge of debt securitization. One spectacular example was the boom in mortgage-backed securities. As the creation and sale of securitized mortgage paper exploded, hundreds of billions of dollars in mortgage debt was moved off the balance sheets of the commercial banks and savings-and-loan institutions and into the portfolios of non-bank lenders and investors. By shrinking bank assets, this trend directly diminished broad money growth.

As the markets boomed, brokers vied to create ever more esoteric and complex financial instruments. Prime examples are the Collateralized Mortgage Obligations (CMOs) which divided mortgage pools into different classes of securities with differing maturities and interest-rate risk characteristics. Huge quantities were sold, partly to banks, though mostly to heavily leveraged institutional buyers. At the same time, hybrid derivative instruments were devised with the help of sophisticated computer modelling techniques and math experts that promised to hedge these exotic securities against interest rate risks. This supposed protection, of course, greatly encouraged the speculation.

In practice, though, Wall Street's smug presumption that computer models could accurately model the relative price action of complex derivatives in all kinds of market environments proved catastrophic. One high-profile victim of the CMO disaster was David Askin, manager of a group of hedge funds promoted as offering "*risk balanced, market neutral investment portfolios with an annual return objective of 15% and more.*"

In reality, Askin held heavily-leveraged CMO residual securities — highly volatile securities and virtually impossible to value — mainly financed by cheap security repos (short-term financing, in other words). With capital of $595 million raised from institutional investors, he controlled $1.5 billion worth of CMO's. As interest rates fell, investment returns were extremely high. Once rates started to rise, however, price declines quickly triggered margin calls. Unable to meet them, Askin was forced to sell his portfolio at fire-sale prices. Investors in his fund lost everything; even his lenders lost considerable sums.

The collapse of the Askin funds, though only a drop in the speculative tide, gives an idea of the extent and the complexity of the financial instruments contributing to the current speculative maelstrom. To really understand the implicit risks of all of this, we need to look more closely at the resulting liquidity conundrum that manifests itself in the bizarre contrast of a rampant financial boom against a backdrop of record-low money and liquidity growth.

While the main reason for the abnormal liquidity pattern in the U.S., as explained, is the precipitous expansion of the non-bank financial intermediaries, conventional wisdom holds that their activity is largely irrelevant because from a monetary perspective they don't "create money." They are, after all, only supposed to be "intermediaries."

This narrow focus on money creation as the decisive gauge for monetary effects, in our view, is a cardinal error. After all, these institutions have blasted trillions of dollars into the U.S. economy and its financial markets over the last two to three years. That's what's relevant in understanding the bubble. Focusing only on money is completely misleading in this regard.

THE ROLE OF THE NON-BANKS

Just what is the mechanism of the non-banks' involvement and influence? The key point about these intermediaries is that they generally draw the money that they lend or invest from sources other than banks. What really happens is that they draw money from the existing bank deposits of corporations, pension funds, insurance companies, private households. . . etc. Therefore, their activity is independent of current money growth and, by the way, independent of any monetary limitation such as the reserve requirements that banks must observe.

An example is instructive. Let's trace the process of how these huge flow effects of the non-banks come about without any visible effect on the broad money stock by looking at the case of mutual funds. During 1992-93, equity and bond mutual funds raised a total of $516 billion from the public. Most of the buyers of these funds would have written cheques on their demand deposits and mailed them to the fund companies. In return, they received claims on the mutual funds . . . that is, mutual fund shares. The mutual funds deposited the cheques. They then used these deposits to purchase stocks or bonds. The sellers of these securities to the mutual funds, in turn, were paid with the same existing demand deposits. As the new holders of the deposits, the sellers would then have spent them on something else — goods and services, other assets, or perhaps they may have parked these funds in certificates of deposit (CD's).

What is the end-effect? No new deposits are created; no money is created. The key effect is that the money stream into the stock and bond market was increased by $516 billion, forcing up prices. The $516 billion, although repeatedly changing ownership, never left the banking system. Total outstanding bank deposits and bank reserves, therefore, remain unchanged.

What we see in this analysis is that the mutual fund industry simply recycled existing bank deposits and generated a huge flow of investible funds into the stock and bond market by printing and selling a money substitute called "mutual fund shares." Another decisive point is this: Since deposits and reserves remain at the full disposal of the banks, they are able to maintain their existing loans and investments.

In essence, this tremendous proliferation of non-bank intermediaries can be viewed as adding yet another layer of financial leverage to the banking system. While the banks multiply credit and deposits on the base of their reserves provided by the Federal Reserve, the non-bank institutions build a secondary credit and investment pyramid on top of the banking system.

POPULAR MISCONCEPTIONS

As we explained earlier, the ultimate cause of the "bubble" was the prolonged imposition of a 3% Fed funds rate. On the one hand, the resultingly large and abnormal spread between short- and long-term interest rates overstimulated the growth of the non-bank intermediaries who aggressively seized the opportunity to exploit a lucrative yield curve. On the other side, it triggered a yield panic — particularly among interest income dependent investors, mostly the elderly — and provoked the famous "*dash from cash*."

That's an unpalatable explanation, to be sure. Today, it's customary to explain away any disturbance in the relationship between money growth and other aggregates as reflecting a change in money velocity. Superficially, that's correct. The problem is that it is unfortunate terminology because it confuses more than explains the underlying causation.

This velocity approach, primarily resulting from the work of Professor Irving Fisher, was preceded by the so-called "cash balance" approach or Cambridge Equation. These two theorizations are just two different views of the same phenomenon. Importantly, it is the "cash balance" approach that focused on the decisive underlying causation. It addressed the disposition of people to hold money balances in relation to their income or wealth. This was an important insight which today's monetarists have buried with their axiom that money demand is stable. Clearly, this assumption is not true.

CHANGING DEMAND FOR MONEY

This topic reminds us of the story our parents told us about the German hyperinflation of the early 1920s. Father's salary was paid twice a week at a certain hour of the day. Once paid, he would run to meet mother who would be waiting at the factory gate to hand her the money. As soon as she had the money she would run to buy anything available to beat prices that were rising by the hour. Expressed in theoretical language, what happened here was that the entire money stock was in rapid circulation. No one wanted to hold cash balances, just goods that were rising in price. In effect, the demand for money was seriously distorted. It was abnormally low.

This was our first lesson in monetary theory. It taught us the immense importance of a change in the general desire of the public to hold money balances. Near the end of the German hyperinflation, price indexes were rising several hundred times faster than the money supply. It had become a "velocity" inflation. And just as today, nobody understood the phenomenon. Many experts, their eyes fixed on the soaring gap between inflation and money growth, warned of an impending deflation and demanded the printing of even more money. In effect, for a time, an inflation was unleashed without a corresponding increase in money. All the while, though, the public was actually becoming totally illiquid.

The parallel between that inflationary experience of the past and the present financial boom is obvious. The Germans in 1922 fled their depreciating money by running into goods and services; the Americans in 1992-93 fled their low-yielding money balances into financial assets. In Germany, the phenomenon forced up the prices of goods and services far in excess of current money growth; in the recent U.S. boom, the race from cash did the same to stock and bond prices.

So what next? The "classical" economists — the ones that lived by the "*old-fashioned Laws of economics*" — regarded any flight from cash as an act of inflation and equivalent to excessive money growth. It's exactly this dynamic that the Greenspan Fed and the financial community have neither recognized nor

understood. Instead, they hailed the flight from cash they triggered with the slogan "*cash is trash,*" identifying it as a healthful shift and justifying the stratospheric prices for stocks and bonds.

In the basic model of the "classical" school of economists — to which we have always subscribed — over the long-run, interest rates are determined by the balance between the demand for loanable and investible funds and the supply of savings furnished from unspent current income. The classical economists focused on the long run and on financial balance.. Seen in this light, the recent widespread belief that the world could have the lowest interest rates in history while budget deficits exploded and available savings fell was an incredible absurdity. It's simply so unbelievable. Yet, it was widely believed.

The promoters of this bogus theory, essentially assuming that the demand for securities is unlimited, probably don't even know that their nonsense descends from Keynes. He was the one and only leading economist who expressly postulated that interest rates had nothing to do with savings and credit demand, only with bullishness or bearishness towards securities . . . that is, changes in liquidity preference. In the view of Keynes, the whole stock of money in existence is potentially available for the buying of securities.

Taking this view, all that is required to drive interest rates down is to demolish the public's desire and demand for liquidity. That's precisely what the Greenspan Fed and Wall Street malignly managed to do with great success. The quote on the front page certainly documents this complicity of the Fed in the 1920s.

THE LESSONS OF HISTORY RELIVED

"Cash balance" or "velocity" effects, no doubt, form part of every inflation, though to different degrees. However, they always play a role in the worst crashes since their impact on overall liquidity is the most treacherous and the most damaging. They are the surest and fastest way into a liquidity crisis. As a matter of fact, it explains a great part of what happened in the U.S. during the stock market boom of 1927-29.

Owing to Milton Friedman, it has become the conventional view that the Depression of the 1930s was the result of policy mistakes made by the Fed after the start of the stock market crash. Before his viewpoint captured the mainstream, the widely-held expert opinion was otherwise. The causes of the crash and the Depression were widely linked to the previous speculative excesses of the 1920s.

What was stressed as the aggravating causes then has many parallels today: a falling willingness to hold money balances associated with an explosive growth of non-bank intermediaries — mainly broker loans for margin speculation and investment trusts. In September 1929, these loans amounted to $8.5 billion which, seen in comparison to total bank loans and investments of $35 billion, was gigantic.

Two other striking parallels with 1928-29 need to be mentioned: The recent stampede into equity mutual funds is no different from the locust-like multiplication of investment trusts that occurred in the late 1920s. As well, it was an abnormal rate spread that played a crucial role in driving non-bank borrowing and lending to absurd excesses. While today, it's the spread between bank deposit rates and bond yields; then it was the spread between bank deposit and call money rates, equivalent to today's securities repo rate.

BOOM, BUBBLE, BURST, BUST

Must a financial bubble always bust? Why they always do is because of the widespread impairment of liquidity that occurs during the preceding speculative boom phase. A bubble breeds and masks a drastic deterioration in liquidity. The whole financial system becomes overextended and overleveraged.

As people become increasingly disillusioned with the performance of the financial markets, they first cut back on their new purchases. It's this change that always finishes bull markets. Then, over time, illiquidity and growing disillusionment take their toll. The real big trouble starts when more and more people decide to rebuild their depleted liquidity by selling their security holdings.

Only individuals acting in isolation can raise their liquidity in this way, not the community as a whole. There is no way for investors and non-bank institutions to improve their liquidity by selling securities. The reason? Simply, that for every seller there must be an equivalent buyer; in order for someone to increase liquidity, someone must be willing to give up an equal amount. Any widespread attempt to switch from securities back into cash would spell immediate disaster. It would only ravage market prices and reduce market liquidity even further.

In short, the dash to cash that is inevitable someday won't increase its supply. The only way that can happen is by banks flooding the system with new liquidity through massive increases in their loans and investments. In 1929, the banks did this by taking over many of the broker loans. That being virtually unthinkable this time, we expect that these intermediaries will experience collapsing loans and investments. Wealth and liquidity will spiral down in a rapid contraction as declining asset values are likely to trigger more margin calls and more liquidations of speculative positions. What actually happens instead is that the money supply contracts.

Many people simply presume that the Fed can take care of any crisis situation that might arise, just as it did during the stock market crash of 1987. We don't think that is possible this time. The liquidity problems that have cumulated during the last three to four years are far more pervasive than ever before and are therefore far beyond the control of the Fed. What's involved is an entire financial system that's overleveraged as never before, not to mention an overindebted consumer.

DOLLAR COMPLICATIONS

It's self-evident that the underlying weakness in the dollar makes everything worse. A dollar crisis could well be the catalyst that finally shatters the financial markets. So far, most people are more surprised than alarmed over the dollar's decline.

Is a dollar crisis in the cards, and when could it happen? We think it's highly likely once financial markets awaken to the fact that the U.S. economy is again weakening. For the time being, the perception that the economy is continuing to hum along, seemingly impervious to rising interest rates, is acting to prop up the dollar. Once this belief crumbles, the dollar is in for deep trouble. Markets aren't at all prepared for a sharply weaker economy that will require easier money.

As we have always stressed, the dollar's weakness is rooted in structural causes — abysmal investment and savings ratios, a super-sized budget deficit, insufficient capacity growth in manufacturing, all of this reflected in a soaring current-account deficit now hitting $140 billion. As long as U.S. financial markets looked attractive, the foreign capital to finance this deficit was readily forthcoming. But that's no longer the case. Therefore, the external deficit now acts to pull down the dollar. It's as simple as that.

No doubt, the prospects for the U.S. economy determine the outlook for the dollar. As it happens, we don't share the market's optimism for either one. It's implicit in our analysis of the overinflated financial flows that the U.S. economy is heading for a sharp downturn. But wouldn't that be bullish for financial assets by way of lowering interest rates and boosting the bond markets? In short, no. Given the enormous bubble and existing low supply of savings, any new slowdown would quickly widen already-high government budget

deficits around the world. As well, a falling dollar and stock market will turn overall market sentiment very black all around.

CONCLUSIONS

While a semblance of stability has returned to stock and bond markets in recent weeks, there is no foundation for a sustained recovery to say the least. Our analysis of the money flows that inflated stock and bond prices show that the speculative excesses were endemic, extreme and complex. The legacy is that the financial system remains utterly vulnerable.

Above all, the stubborn refusal of most investors to accept losses keeps the markets in precarious balance for the time being. Any renewed decline threatens a "capitulation" phase. Particularly vulnerable are stock markets. So far, their declines have been minor relative to the bond markets.

Having created the bubble, the Fed now seeks to gently unwind it with a policy of timid rate hikes. The effort is doomed to fail. History proves that financial bubbles can only be prevented, never cured.

According to our analysis, the Fed has definitely lost control. Liquidity in the U.S. markets and economy has become a function of monetary velocity that depends on a continuous flight of the public out of liquid money balances. That can't last.

Already, despite a continuing steep yield curve, the flight from cash has sharply slowed. Once the rush for safety begins — a so-called "*dash to cash*" — the cataclysmic crash will inevitably arrive. Both stocks and bonds will suffer, reverberating a crisis around the world.

There is no way that the Fed can prevent the crash. All it can do is to try boosting the money supply — the liquidity supply — by adding bank reserves. But, this won't work in the end. It's more than doubtful that the banks will respond with an aggressive expansion of their bond portfolios while the financial markets are crashing.

Given the grave circumstances, capital preservation remains the top priority. We continue to reiterate our preference for cash and short securities of the hard currency countries — Germany, Austria, Switzerland and the Netherlands.

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